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# THE TAXATION OF GIFTS AND BEQUESTS IN AUSTRALIA: A PROTOTYPE FOR TRANSFER TAX REFORM IN THE UNITED STATES?

Jeffrey S. Kinsler<sup>†</sup>

*Abstract:* Australian tax law presents a possible prototype for the reform of gift taxation in the United States. Unlike the United States, Australia does not impose a separate transfer tax on gifts and bequests. Rather, gratuitous transfers of appreciated property are treated as capital gains under Australian tax law, exposing donors to income taxation. In an effort to interject the Australian model of taxation into the already robust debate over how best to reform the U.S. transfer tax system, this article examines the advantages and disadvantages of the Australian system and the Australian Income Tax Assessment Act ("ITAA").

## I. INTRODUCTION

There is no shortage of proposals to reform the estate and gift tax scheme in the United States. During the past few decades, several thoughtful plans have been submitted to overhaul the existing estate and gift tax system, ranging from treating gratuitous transfers as gross income<sup>1</sup> to adopting an entirely new form of taxation, such as an accessions tax<sup>2</sup> or wealth tax.<sup>3</sup> Suffice it to say, most commentators agree that some sort of transfer tax<sup>4</sup> reform is needed. There is no agreement, however, on how best to implement such reform.

What's wrong with the existing U.S. estate and gift tax system? The answer to this question could fill a treatise, and thus is beyond the scope of this article.<sup>5</sup> But, briefly stated, Congress had two goals in mind when it established the estate and gift tax system.<sup>6</sup> The first goal was to raise revenue, a goal transfer taxes share with all new taxes. But transfer taxes

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<sup>1</sup> See, e.g., Joseph S. Platt, *Integration and Correlation—The Treasury Proposal*, 3 TAX L. REV. 59 (1947).

<sup>2</sup> See, e.g., William D. Andrews, *The Accessions Tax Proposal*, 22 TAX L. REV. 589 (1967).

<sup>3</sup> See, e.g., George Cooper, *Taking Wealth Tax Seriously*, 34 REC. ASS'N B. CITY N.Y. 24 (1979).

<sup>4</sup> As used herein, the term "transfer tax" means federal estate and gift taxation.

<sup>5</sup> The exclusive focus of this article is the taxation of lifetime and testamentary gifts in Australia. Stamp taxes and other death duties are beyond the scope of this article.

<sup>6</sup> A third goal was to add a measure of progressivity to the income tax.

are not very adept at raising revenue; only about one percent of federal revenue comes from estate and gift taxation,<sup>7</sup> and surely a substantial portion of this revenue is used to maintain the transfer tax as an independent system of taxation. The second goal was the abolition of family dynasties in the United States. It was thought that a progressive tax on "fortunes swollen beyond all healthy limits"<sup>8</sup> was necessary to condemn "the selfish millionaire's unworthy life."<sup>9</sup> But, experts agree, "the estate tax has done very little to dilute the greatest concentrations of wealth,"<sup>10</sup> as evidenced by the perpetual riches of the Forbes, Du Pont and Rockefeller families, to name just a few.

This article examines the taxation of non-charitable gifts in Australia. It has one modest goal: to introduce an alternative system of taxing gratuitous transfers, a system, perhaps, capable of replacing, in whole or part, the estate and gift tax scheme in the United States. This article is not an economic or empirical study of transfer taxation, and any cost-benefit analysis of supplanting the U.S. estate and gift tax system with one based on Australian law will be left to future writers. More importantly, this article does not necessarily advocate replacing the U.S. estate and gift tax with an Australian-based model; it merely proposes that such a model be included in the already robust debate over how best to reform the transfer tax in the United States.

## II. TAXATION OF GIFTS AND BEQUESTS IN AUSTRALIA

After decades of protest from farmers and small business owners, Australia abolished its separate system of estate and gift taxation in the late 1970s.<sup>11</sup> For several years thereafter, lifetime and testamentary gifts were entirely immune from taxation. In 1985, however, Australia implemented a capital gains tax ("CGT") which encompassed not only sales of property, but also gratuitous transfers.<sup>12</sup> Under Australia's CGT, lifetime gifts of property are subject to taxation in a manner similar to capital assets sold for

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<sup>7</sup> BORIS I. BITTKER, ET AL., *FEDERAL ESTATE AND GIFT TAXATION* 1 (7<sup>th</sup> ed. 1996).

<sup>8</sup> 18 THE WORKS OF THEODORE ROOSEVELT 578 (1925).

<sup>9</sup> ANDREW CARNEGIE, *THE GOSPEL OF WEALTH* 14, 21-22 (1962), *quoted in* BITTKER ET AL., *supra* note 7, at 4.

<sup>10</sup> Michael Graetz, *To Praise the Estate Tax, Not to Bury It*, 93 YALE L.J. 259, 271 (1983).

<sup>11</sup> See generally Willard H. Pedrick, *Oh, To Die Down Under! Abolition of Death and Gift Duties in Australia*, 35 TAX L. 113 (1981).

<sup>12</sup> See Australian Income Tax Assessment Act §§160A-160ZZU (1936) (hereinafter "ITAA").

profit.<sup>13</sup> Most testamentary transfers, however, elude CGT until re-transferred by the donee.<sup>14</sup> This Article will briefly examine the taxation of lifetime and testamentary gratuitous transfers under Australian law. However, before one can undertake an examination of Australia's taxation of gifts and bequests, a preliminary question must be answered: What is a "gift?"<sup>15</sup>

#### A. *Definition of Gift*

Determining what is a "gift" is essential to taxation in both the United States and Australia.<sup>16</sup> In the United States, truly gratuitous transfers are exempt from income taxation, but are subject to gift tax.<sup>17</sup> On the other hand, transfers intended as compensation for services are ordinarily subject to income taxation, but not gift taxation.<sup>18</sup> Similarly, in Australia truly gratuitous transfers are not considered income to the recipient, but may be subject to capital gains tax.<sup>19</sup> Conversely, transfers intended as compensation for services are subject to income taxation, but not capital gains tax. As a consequence, defining the term "gift" is a prerequisite to taxation in both countries.

##### 1. *U.S. Definition*

Economists define income to include all monetary gains, regardless of source.<sup>20</sup> Gifts are obviously included in this definition. However, the legal definition of income, both in the United States and Australia, excludes gratuitous transfers. Under the Internal Revenue Code, a gift is not considered income to the donee for income tax purposes,<sup>21</sup> nor is the donor

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<sup>13</sup> ITAA § 160M(1) (1936).

<sup>14</sup> ITAA § 160X(3) (1936). If an asset is disposed of at death, it is not considered a disposal for purposes of CGT and thus is not taxed.

<sup>15</sup> The taxability of gifts to qualified charities, scholarships, prizes and awards are beyond the scope of this article.

<sup>16</sup> This section relates exclusively to the taxation of lifetime gifts. Courts are rarely called upon to distinguish testamentary gratuitous transfers from income.

<sup>17</sup> I.R.C. §§ 102(a), 2501 (1996).

<sup>18</sup> I.R.C. § 61 (1996).

<sup>19</sup> ITAA, § 160ZD(2) (1936).

<sup>20</sup> See generally *Goodwin v. Hartford Life Ins. Co.*, 359 F.Supp. 20, 24 (W.D. Pa. 1973). "The economist's definition of 'income' is the money value of the net accretion in one's economic power between two points of time." *Id.* at 24.

<sup>21</sup> I.R.C. § 102(a) (1996).

entitled to a deduction for gratuitous transfers to non-charitable beneficiaries.<sup>22</sup> Rather, non-charitable gratuitous transfers are subject to a separate system of taxation. This separate system of taxation imposes an excise tax on the gratuitous transfer of property. In other words, a "gift" is exempt from income taxation in the United States, but is subject to excise tax.<sup>23</sup> Accordingly, defining the term gift is a necessary threshold to determining which system of taxation applies to a given transaction.

Considering its enormous importance to taxation, one would suspect that the term "gift" is precisely defined in the Internal Revenue Code, yet the term is not defined anywhere in the Code, either for income tax or gift tax purposes. The Code does, however, furnish some guidance in determining if a gift has been made for gift tax purposes, providing that "[w]here property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeds the value of the consideration shall be deemed a gift."<sup>24</sup> Aside from this provision, the Code is silent on the definition of gift. Consequently, courts have been forced to confront borderline transactions on a case by case basis.<sup>25</sup>

As a result of such ad hoc analysis, the income tax and gift tax each has developed its own independent criteria of the taxability of gifts.<sup>26</sup> In gift tax cases, the courts have declared that donative intent, an essential element of a gift under common law, is not required for gift taxation. Rather, the gift tax is imposed on the basis of objective factors of the transfer and the circumstances under which it was made, not on the subjective motives of the donor.<sup>27</sup> By contrast, the term "gift," as defined for income taxation, turns on the subjective intent of the donor. Under such reasoning, transfers made out of friendship, devotion, affection, gratitude, personal regard or pity are gifts and thus elude income taxation,<sup>28</sup> but transfers made to reward past service or to promote future service are income.<sup>29</sup>

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<sup>22</sup> See ITAA § 78. Nor is there capital gain or loss from a gift. I.R.C. § 1211(b) (1996) (capital transactions require a "sale or exchange").

<sup>23</sup> Not all lifetime gifts are taxed, however. There are so many exclusions, deductions and credits in the gift tax system that some commentators have declared it voluntary. See, e.g., George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161 (1977).

<sup>24</sup> I.R.C. § 2512(b) (1996).

<sup>25</sup> See, e.g., *Lockard v. Commissioner*, 166 F.2d 409 (1st Cir. 1948); *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

<sup>26</sup> *Lockard v. Commissioner*, 166 F.2d 409 (1st Cir. 1948).

<sup>27</sup> *Commissioner v. Wemyss*, 324 U.S. 303 (1945).

<sup>28</sup> See, e.g., *Stanton v. United States*, 363 U.S. 278 (1960).

<sup>29</sup> See, e.g., *Commissioner v. Dubenstein*, 363 U.S. 278 (1960).

The inconsistency of these decisions has reinforced the principle that "bad facts make bad law," as recognized by Judge Frank:

At the bottom of [taxpayer's] contentions is this implied assumption: The same transaction cannot be a completed gift for one purpose and an incomplete gift for another. Of course, that is not true . . . . Perhaps to assuage the feeling and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in several statutes, calling it "gift" in the gift tax law, a "gift" in the income tax law, and a "geft" in the estate tax law.<sup>30</sup>

Judge Frank aptly summed up the uncertainty surrounding the meaning of gift in U.S. tax law. But, compared to Australian tax law, the U.S. definition of gift is a model of clarity, because Australian courts are asked to do something their American counterparts are not: differentiate between employer compensation and gratuitous transfers. Under U.S. tax law, transfers made by employers are not, with few exceptions,<sup>31</sup> considered gifts for either income tax or gift tax purposes.<sup>32</sup> As a result, nearly all such transfers are included in the recipient's gross income. While the purpose of this article is to introduce Americans to Australian gift taxation, this article does not suggest that the United States adopt Australia's definition of the term "gift." On the contrary, Australian law makers should consider adopting a provision similar to section 102(c) of the Internal Revenue Code, which excludes most transfers made by employers to employees from the definition of gift. As demonstrated below, such a provision would vastly simplify Australian tax law.

## 2. Australian Definition

Under Australian tax law, gratuitous transfers of property are placed in three different categories: some voluntary transfers of property are subject to income taxation,<sup>33</sup> others are subject to capital gains taxation<sup>34</sup>

<sup>30</sup> Commissioner v. Beck's Estate, 129 F.2d 243, 246 (2d Cir. 1942).

<sup>31</sup> Treas. Reg. § 1.102-1(f)(2) (transfers to the natural objects of an employer's bounty, such as the employer's spouse or children, will not be considered income if the employee can show that the transfer was not made in recognition of the employee's employment).

<sup>32</sup> I.R.C. § 102(c) (1996).

<sup>33</sup> See, e.g., F.C.T. v. Dixon (1952) 86 C.L.R. 540.

and still others are exempt from taxation altogether. In determining which category applies to a specific transfer, the income tax is the starting point. If the transfer is included in the donee's income, that ends the analysis.<sup>35</sup> If the transfer is not income, then it must be tested under the CGT.<sup>36</sup> If it is subject to CGT, the analysis is over. If it eludes income taxation and CGT, the transfer is non-taxable.<sup>37</sup>

For income tax purposes, section 25(1) of the Australian Income Tax Assessment Act ("ITAA") provides that the assessable income of a taxpayer includes gross income derived directly or indirectly from all sources. The term "income," however, is not defined in the ITAA, and the ITAA is silent on the distinction between gifts and income.<sup>38</sup> Instead, income has been defined by common law, and supplemented where necessary by legislation.<sup>39</sup> According to common law concepts, income requires a connection between the receipt of payment and some form of employment or business;<sup>40</sup> in other words, there must be a nexus between the transfer of property and the donee's past, current or future services. Under the nexus test, a pure windfall, such as a gift, inheritance or lottery win, is exempt from income taxation.<sup>41</sup>

Some items are easy to categorize. An employee's weekly salary, for example, is definitely income, as are periodic performance bonuses.<sup>42</sup> At the other extreme, gifts exchanged between family members and friends on holidays and birthdays are not income.<sup>43</sup> In between these two extremes is a large gray area encompassing extraordinary transfers by employers, clients and customers. Such items will be included in the income of the recipient if the amount was the "product" of an income earning activity on the part of the recipient.<sup>44</sup> On the other hand, a mere gift from an employer to an

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<sup>34</sup> ITAA § 160ZD(2) (1936).

<sup>35</sup> See generally ITAA § 6(1) (1936). If the transfer is income, it will be taxed like all other income under §17. ITAA § 17 (1936).

<sup>36</sup> ITAA §§ 160A-160ZZU (1936).

<sup>37</sup> Australia has no gift taxation. See discussion *supra* Part II.

<sup>38</sup> See generally ITAA § 6(1) (1936).

<sup>39</sup> ABE I. GREENBAUM, AUSTRALIAN INCOME TAX LAW: STUDY GUIDE AND CASEBOOK COMPANION 54 (1991).

<sup>40</sup> *Id.* at 55.

<sup>41</sup> *Id.*

<sup>42</sup> ITAA § 6(1) (1936) (defining "income from personal exertion").

<sup>43</sup> ABE I. GREENBAUM & RICHARD E. KREVER, AUSTRALIAN INCOME TAXATION: A CONCISE CASEBOOK 8 (1994).

<sup>44</sup> One factor that indicates income is whether the employer claimed a deduction for the payment. Aust. Tax Ruling MT 2042.

employee motivated by personal friendship and unrelated to the employment relationship would not constitute income.<sup>45</sup> But the lack of a legal obligation to pay does not necessarily preclude it from being income.<sup>46</sup>

The "product of employment" test is fact-sensitive and, as such, often leads to litigation. The test turns on the degree of connection between the payment and the provision of service,<sup>47</sup> and is purportedly an objective test. The test looks at the actual character of the payment in the hands of the donee. "Gains that fail to satisfy the nexus test may nevertheless acquire an income character if they exhibit income characteristics . . . or if they are in lieu of compensation."<sup>48</sup> Australian courts have identified certain factors to be used to determine whether a voluntary transfer is subject to income tax. A brief examination of the four leading cases should assist readers in distinguishing true gifts from income under Australian law.

In *Hayes v. F.C.T.*,<sup>49</sup> Hayes had been employed by Richardson as a financial advisor. On Hayes' advice, Richardson incorporated his company, which prospered until Richardson retired. Soon after Richardson retired, the company began to falter. Richardson returned on the condition that he would have full control over the company and all of its shares.<sup>50</sup> In order to give Richardson control over all of the shares, Hayes was forced to transfer his shares to the corporation. In exchange, the company assured Hayes that it would "make it up to him."<sup>51</sup> The company again became prosperous and a share issue was made to raise capital. Some of these new shares were given to Hayes.<sup>52</sup> The Australian Tax Commissioner asserted that the shares were assessable income under section 25(1).<sup>53</sup> The Australian High Court disagreed, concluding that the payment did not have an income character because the motive of the transfer was the personal relationship between Richardson and Hayes, and not compensation for services performed by Hayes.<sup>54</sup> Hayes had not worked for Richardson for three years before the transfer, and did not expect any additional compensation. The Court based its decision on the fact that there was no apparent

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<sup>45</sup> JEFFREY WAINCYMER, *AUSTRALIAN INCOME TAX PRINCIPLES AND POLICIES* 120 (1993).

<sup>46</sup> *Id.* at 120.

<sup>47</sup> GREENBAUM, *supra* note 39, at 56-57.

<sup>48</sup> GREENBAUM & KREVER *supra* note 43, at 6.

<sup>49</sup> *Hayes v. F.C.T.* (1956) 96 C.L.R. 47.

<sup>50</sup> *Id.* at 49.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 50.

<sup>53</sup> *Id.* at 53-54.

<sup>54</sup> *Id.*



connection between the receipt of the shares and any income producing activity by Hayes.<sup>55</sup> In other words, the shares were not the "product of employment."<sup>56</sup>

In *F.C.T. v. Dixon*,<sup>57</sup> the employer informed its employees that should they enlist for military service. The employer would make up the difference between their current wages and their military pay. Dixon was aware of this policy when he enlisted. During his term in the military, Dixon received payments from his employer under the stated plan. Upon his discharge in 1945, Dixon returned to his old job, although he had no prior arrangement to do so.<sup>58</sup> The Commissioner assessed income taxation on Dixon for the amount of the supplemental payments, and this assessment was upheld by the Australian High Court.<sup>59</sup> The majority of the Court found that the payments had the character of income, even though they were received while Dixon was in the employ of the Army.<sup>60</sup> The Court considered two factors determinative. The first was the regularity of the payments and the taxpayer's expectation of payment:

Because [the payment] was an expected periodical payment arising out of circumstances which attended the war service undertaken by the taxpayer and because it formed part of the receipts upon which he depended for the regular expenditure upon himself and his dependents and was paid to him for that purpose, it appears to us to have the character of income . . . .<sup>61</sup>

The second factor considered important by the court was the expressed object of the payments. The payments were designed to supplement the employee's earnings and, as such, were income:

What the employing firm decided to do, and what it really did, in relation to the respondent and others in the same position, was "to make up the difference between their present rate of wages and the amount they will receive." What is paid is not

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<sup>55</sup> *Id.* at 56.

<sup>56</sup> *Id.* at 54-55.

<sup>57</sup> *F.C.T. v. Dixon* (1952) 86 C.L.R. 540.

<sup>58</sup> *Id.* at 540-43.

<sup>59</sup> *Id.* at 542-43.

<sup>60</sup> See generally *id.* at 556-57, 567-68.

<sup>61</sup> *Id.* at 557 (Opinion of Dixon, C.J. and Williams, J.)

salary or remuneration, and it is not paid in respect of or in relation to any employment of the recipient. But it is intended to be, and is in fact, a substitute for the equivalent *pro tanto* of the salary or wages which would have been earned and paid if the enlistment had not taken place. As such, it must be income, even though it is paid voluntarily . . . .<sup>62</sup>

Based on this reasoning, a payment acquires the character of that for which it is substituted. Stated differently, if the payment "looks, smells and feels" like income, it will generally be characterized as income.<sup>63</sup>

In *F.C.T. v. Harris*,<sup>64</sup> the taxpayer had been employed by a bank before his retirement in 1974. Upon retirement, the taxpayer was entitled to a fixed pension. In 1976, the bank notified all pension recipients that, due to high rates of inflation, the bank had decided to make additional lump sum payments to most of the recipients. In accordance with this plan, the taxpayer received \$450 in 1976, \$625 in 1977, \$558 in 1978, and \$558 in 1979. The payments were not based on any discernible formula and were not expected by the taxpayer nor needed by him for support. The Commissioner included the \$450 payment in the taxpayer's 1976 income.<sup>65</sup>

In an effort to clarify the distinction between a mere gift and income, the Full Federal Court<sup>66</sup> summarized the prior case law as follows:

It is clear that the whole of the circumstances must be considered. Whether or not a particular receipt is income depends on the quality in the hands of the recipient. The motives of the donor may be relevant but are seldom, if ever, decisive. The regularity and periodicity of the payment may be a relevant though generally not decisive consideration. A generally decisive consideration is whether the receipt is the product in a real sense of any employment of, or service

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<sup>62</sup> *Id.* at 568 (Opinion of Fullagar, J.).

<sup>63</sup> GREENBAUM, *supra* note 39, at 59.

<sup>64</sup> *F.C.T. v. Harris* 10 A.T.R. 869 (1980).

<sup>65</sup> *Id.* at 870-72. Only tax-year 1976 was at issue.

<sup>66</sup> Generally speaking, Australian courts are divided in the same manner as courts in the United States. State and federal actions filed in an Australian federal court are heard by a single federal judge. Appeals are heard by the full court. Final appeals are heard by the Australian High Court.

rendered by the recipient, or of any business, or, indeed, any revenue producing activity carried on by him.<sup>67</sup>

Based on this precedent, the Court concluded that the supplementary payments were not income despite the similarity to the payment in *Dixon*.<sup>68</sup> According to Chief Justice Bowen, there was no apparent relationship—no “nexus”—between the payment and the length of service or the position held by the taxpayer.<sup>69</sup> In addition, the taxpayer did not expect to receive the supplement payments. While the payments may have been “related” to his employment at the bank, Chief Justice Bowen ruled that they were not the “product of his employment” in the sense of being produced by his service.<sup>70</sup>

Although the three prior cases involve the employee/employer relationship, the same analysis applies to situations where clients make gifts to independent contractors. In *Scott v. F.C.T.*,<sup>71</sup> the taxpayer was a practicing attorney. He received a £10,000 gift from the widow of a former client and close friend.<sup>72</sup> The widow was a client of the attorney at the time of the gift; the attorney was administering the estate of her late husband. The attorney had been fully paid for all services.<sup>73</sup> The Commissioner included the £10,000 gift in the attorney’s income, but was overruled by the High Court.<sup>74</sup>

The Court stated that whether a particular receipt is income depends upon its quality in the hands of the recipient. It does not depend upon whether it was a payment that the payer was lawfully obliged to make. Gratuities regularly received as an incident of a particular employment, such as tips, are income, while gifts of an exceptional kind do not ordinarily form part of an employee’s income.<sup>75</sup> In this case, the Court found that the money was not assessable as income because:

The [client], I assume, would not have made her gift to the taxpayer if she had not appreciated his help to her and his

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<sup>67</sup> *F.C.T. v. Harris* 10 A.T.R. at 872 (Bowen, C.J.) (citations omitted).

<sup>68</sup> *Id.* at 872-73.

<sup>69</sup> *Id.* at 872.

<sup>70</sup> *Id.* at 872-74.

<sup>71</sup> *Scott v. F.C.T.* (1966) 117 C.L.R. 514.

<sup>72</sup> *Id.* at 519-20.

<sup>73</sup> *Id.* at 516-19.

<sup>74</sup> *Id.* at 523.

<sup>75</sup> *Id.* at 526.

friendship. If he had not acted for her as he did in relation to her husband's estate, if he had not been a friend of her husband, it probably would not have occurred to her to make him a beneficiary in her distribution of part of the moneys that she got from the estate.<sup>76</sup>

Thus, it is not enough that the employment is related to and motivates the generosity. To say that the employment motivated the payment is not the equivalent of saying that it is the "product" the taxpayer's employment or service. Unless a payment is the product of the taxpayer's employment, it will not be assessable income.<sup>77</sup>

In sum, if a payment is provided as part of the employee's remuneration, it will automatically acquire an income character. If the payment is provided gratuitously, it will acquire an income character only if certain other factors indicate that the transfer was compensation for past, current or future services. One commentator summarized the relevant factors as follows:

- (1) The whole of the circumstances must be considered.
- (2) The identity of the donor may be relevant, but if payments are incidental to the employee's services, they need not come from the employer.
- (3) The motive of the donor may be relevant, but will seldom be decisive.
- (4) Periodicity and regularity of receipt indicates income, but is not decisive. If the true nature of the payment is discernible, periodicity or lack thereof will have no effect. Moreover, if the taxpayer looks to the payments for support, they are more likely to be income than gifts.
- (5) If sufficiently connected to an earning activity, it does not matter whether the payment is for past, present or future services.
- (6) The manner of payment is irrelevant.
- (7) It is the character of the payment in the hands of the donee, not the donor, that matters. What may be income in one person's hands may not be such to another.

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<sup>76</sup> *Id.* at 528.

<sup>77</sup> *Id.* at 526-27.

(8) A payment made as substitution for potential income is income.<sup>78</sup>

Although key concepts in taxation, the terms "income" and "gift" lack precise definitions under Australian law. Most of the confusion relates to extraordinary payments made by employers to employees. Much of this confusion could be avoided if Australia adopted a provision similar to section 102(c) of the Internal Revenue Code. But the primary concern of this article is not the definitions of "income" or "gift." The purpose of this article is to introduce the taxation of true gifts under Australian CGT.

### *B. Australian Taxation of Lifetime Gifts*

Unlike the separate form of excise tax imposed on gifts in the United States, in Australia inter vivos gifts are taxed under the Capital Gains Tax,<sup>79</sup> which is part of the income tax system. Australia's CGT, which became effective on September 19, 1985, is necessarily complicated (like its U.S. counterpart) and is comprised of numerous, detailed provisions. This article provides only a brief synopsis of the pertinent provisions of the CGT; a comprehensive understanding of Australia's CGT requires a lengthy analysis of the ITAA and the case law interpreting it.

The primary rationale for the introduction of the CGT was horizontal tax equity. Before the enactment of the CGT, the Australian system of taxation was notable for its lack of a general tax on capital gains. Without the CGT, the tax law favored those who received income in the form of capital gains over those who received wages.<sup>80</sup> For example, before the CGT a taxpayer who earned \$25,000 of salary would pay \$5,000 in tax (assuming a 20% flat rate of income taxation), whereas a taxpayer who derived a capital gain of \$25,000 ordinarily would pay no tax. The CGT was designed to mitigate this perceived inequity.<sup>81</sup>

Unlike the capital gains tax in the United States, Australian CGT encompasses not only sales and exchanges of capital assets, but also gratuitous transfers.<sup>82</sup> Under the CGT, net capital gain for the year is

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<sup>78</sup> WAINCYMER, *supra* note 45, at 124-26.

<sup>79</sup> ITAA §§ 160A - 160ZZU.

<sup>80</sup> RONALD K. KEMP, ET AL., PRINCIPLES OF TAXATION 87 (4th ed. 1991); *see also* REGINALD I. BARRETT & PETER C. GREEN, PRINCIPLES OF INCOME TAXATION 42-43 (3d ed. 1986).

<sup>81</sup> *Id.* at 87.

<sup>82</sup> ITAA § 160M (1936).

included in the taxpayer's assessable income.<sup>83</sup> "Net capital gain" occurs when the capital gain realized during the year exceeds the capital loss incurred during the year and any net capital loss carried forward from previous years.<sup>84</sup> As a general rule, capital gain is calculated for each asset disposed of in the tax year by subtracting the indexed cost base from the consideration on disposal.<sup>85</sup> The starting point for CGT, therefore, is the disposal and acquisition of a capital asset.

### 1. *What is an Asset?*

Section 160A of the CGT defines the term asset as "any form of property" and then provides a non-exhaustive list of examples, which includes options, debts, choses in action, goodwill, and foreign currency.<sup>86</sup> The definition extends to all "property," whether tangible or intangible, except for most automobiles.<sup>87</sup> "Property" is the most comprehensive of all terms in as much as it is indicative and descriptive of every possible interest that a person can have.<sup>88</sup> It includes fee simple ownership as well as lesser interests, but does not include services or labor.<sup>89</sup> As a consequence, the transfer of all property, whether real, personal or incorporeal (except Australian currency and most automobiles), is subject to CGT.<sup>90</sup>

### 2. *Disposal and Acquisition of an Asset*

Section 160M(1) of the CGT sets forth the rules for determining when an asset has been "disposed" of by the transferor and "acquired" by the transferee.<sup>91</sup> According to that provision:

[W]here a change has occurred in the ownership of an asset, the change shall be deemed, for purposes of this Part, to have

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<sup>83</sup> ITAA § 160ZO(1) (1936).

<sup>84</sup> KEMP ET AL., *supra* note 80, at 87.

<sup>85</sup> ITAA § 160Z(1) (1936). By contrast, capital loss is calculated by subtracting the "reduced cost base" of the asset from the consideration on disposal. "Reduced cost base" is not adjusted for inflation, and resembles "adjusted basis" under U.S. tax law. *Id.*

<sup>86</sup> ITAA § 160A (1936).

<sup>87</sup> ITAA § 160A (1936).

<sup>88</sup> *Jones v. Skinner*, 5 L.J. Ch. (NS) 87, 90 (1835).

<sup>89</sup> KEMP ET AL., *supra* note 80, at 89.

<sup>90</sup> Except, of course, transfers of property considered income to the recipient.

<sup>91</sup> ITAA § 160M(1) (1936).

effected a disposal of the asset by the person who owned it immediately before the change and an acquisition of the asset by the person who owned it immediately after the change.<sup>92</sup>

A change of ownership occurs any time the asset is transferred from one person to another, including by means of: (1) the execution of an instrument; (2) the entering into of a transaction; (3) the transmission of the asset by operation of law; (4) the delivery of the asset; (5) the doing of any other act or thing; or (6) the occurrence of any event.<sup>93</sup> In addition, a change in ownership will be deemed to have occurred in certain circumstances, including:

- (a) a declaration of trust in relation to the asset under which the beneficiary is absolutely entitled to the asset as against the trustee;
- (b) in the case of an asset being a debt, a chose of action or any other right, or an interest or right in or over the property—the cancellation, release, discharge, satisfaction, surrender, forfeiture, expiry or abandonment, at law or in equity, of the asset;
- (c) in the case of an asset being a share in or debenture of a company—the redemption in whole or in part, or the cancellation, of the share or debenture; or
- (d) a transaction in relation to the asset under which the use and enjoyment of the asset was or is obtained by a person for a period at the end of which the title to the asset will or may pass to that person.<sup>94</sup>

It is important to note that the rules of “disposal” and “acquisition” do not, unlike their U.S. counterparts, require a sale or exchange.<sup>95</sup> Under the CGT, a disposal and acquisition occurs not only if an asset is sold for cash or exchanged for property of equal value, but also if the asset is transferred as a lifetime gift.<sup>96</sup> For purposes of the CGT, a “gift” occurs, in whole or part, where (1) there is no consideration exchanged for the

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<sup>92</sup> ITAA § 160M(1) (1936).

<sup>93</sup> ITAA § 160M(2) (1936).

<sup>94</sup> ITAA § 160M(3) (1936).

<sup>95</sup> Compare I.R.C. § 1001(a) (1996) with ITAA § 160M (1936).

<sup>96</sup> See ITAA § 160M (1936).

disposal; (2) all or part of the consideration received by the taxpayer in exchange for the disposal cannot be valued; or (3) the asset has been disposed of for less than market value in a non-arm's length transaction.<sup>97</sup>

### 3. *Calculation of CGT*

If a taxpayer disposes of a capital asset that he or she has held for more than twelve months, capital gain is calculated by subtracting the asset's "indexed cost base" from the consideration on disposal.<sup>98</sup> "Consideration on disposal" is generally the amount of money plus the market value of all property received in exchange for the asset.<sup>99</sup> This is similar to the term "amount realized" under U.S. tax law.<sup>100</sup> There is one major difference, however. Under Australian CGT, if an asset is transferred gratuitously, the "consideration on disposal" is deemed to be the market value of the asset at the time of disposal.<sup>101</sup> Stated differently, a donor who makes a gift of a capital asset is deemed to have received consideration in an amount equal to the market value of the asset at the time of the gift. By contrast, under the capital gains provisions of U.S. law, the "amount realized" by a taxpayer who makes a gift is zero.<sup>102</sup>

CGT in Australia taxes only "true gains." True gains are those which exceed the rate of inflation.<sup>103</sup> The taxation of true gains is accomplished through the use of an "indexed cost base" for the asset. The "indexed cost base" is the "cost base" of an asset adjusted for inflation.<sup>104</sup> The "cost base" of an asset is the amount of consideration (money and market value of property) the transferor was required to give to acquire the property plus: (1) the incidental costs to the taxpayer in acquiring the asset (e.g., broker's fees); (2) any expenditure of a capital nature incurred by the transferor to enhance the value of the asset; (3) any capital expenditure incurred by the taxpayer in establishing, preserving or defending title to the asset; and (4) any incidental costs incurred by the transferor in disposing of the asset.<sup>105</sup>

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<sup>97</sup> ITAA § 160ZD(2) (1936).

<sup>98</sup> ITAA § 160AZ (1936).

<sup>99</sup> ITAA § 160ZD(1) (1936).

<sup>100</sup> See I.R.C. § 1001(b) (1996).

<sup>101</sup> ITAA § 160ZD(2) (1936).

<sup>102</sup> I.R.C. § 1001(b) (1996).

<sup>103</sup> See generally ITAA § 160ZH(2) (1936). By using an "indexed cost base," the CGT does not tax gains that merely reflect inflation.

<sup>104</sup> ITAA § 160ZH(2) (1936).

<sup>105</sup> ITAA § 160ZH (1936).



The term "cost base" in the CGT is similar to the term "adjusted basis" under U.S. tax law.<sup>106</sup>

To determine the "indexed cost base" of an asset, the "cost base" is multiplied by the Indexation Factor of the quarter of the year in which the asset was disposed of and divided by the Indexation Factor of the quarter of the year in which the liability to pay the cost arose or was incurred.<sup>107</sup> If the cost base is comprised of several amounts (which would be typical), then several calculations are required. The Indexation Factors are based on the Australian Consumer Price Index ("CPI") and are adjusted quarterly to reflect inflation.<sup>108</sup> For example, the Indexation Factor began as 71.3 for the quarter ending on September 30, 1985 (the first quarter of the CGT) and increased to 72.7 for the quarter ending on December 31, 1985 and has increased every quarter since then.<sup>109</sup> Note that indexation of gains applies only to property held by the taxpayer for more than twelve months before disposal.<sup>110</sup> Gains on property held twelve months or less is determined by subtracting the "cost base" from the consideration on disposal.<sup>111</sup>

The indexation of capital gains is an integral part of Australian tax law. Although indexation has been proposed in the United States, it has never been seriously considered. If one were considering adopting an Australian-model of gift taxation in the United States, indexation would not be an essential component of the model, and should not be considered as part of any proposal to reform the gift tax unless indexation is adopted for all capital gains in the United States. There is no special justification for indexing capital gains arising from gratuitous transfers, as a capital gain on a long-term sale is subject to the same rates of inflation as a gift.

As previously stated, to calculate the gain on the disposal of a capital asset the indexed cost base of the asset is subtracted from the consideration on disposal.<sup>112</sup> A few simple examples should assist readers in understanding this calculation.

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<sup>106</sup> See I.R.C. § 1011 (a) (1996).

<sup>107</sup> ITAA § 160ZJ (1936).

<sup>108</sup> ITAA § 160ZJ(1) (1936).

<sup>109</sup> *Id.*

<sup>110</sup> ITAA § 160Z(3) (1936).

<sup>111</sup> ITAA § 160AY(3) (1936).

<sup>112</sup> *Id.* The donee's initial cost base after the transfer would equal deemed market value of the asset at the time of gift.

*Example A:* An Australian taxpayer purchases a capital asset (e.g., securities) on October 15, 1994 for \$100,000. The taxpayer makes a gift of the asset to a friend on February 13, 1996, more than twelve months after the taxpayer acquired the asset, at a time when the asset had a market value of \$200,000. Assume that the Indexation Factor for the quarter ending on December 31, 1994 was 200 and the Indexation Factor for the quarter ending on March 31, 1996 was 250. The taxable gain is calculated as follows:

Consideration on Disposal (deemed market value)	200,000
Indexed Cost Base = $\$100,000 \times 250/200$	= <u>-125,000</u>
Taxable Gain	\$75,000

*Example B:* An Australian taxpayer purchases an asset (e.g., unimproved real estate) on June 8, 1991 for \$20,000. On January 15, 1993, the taxpayer spent \$10,000 on capital improvements on the asset. On October 12, 1995, the taxpayer gives the property to her daughter as a gift. At the time of the gift, the asset had a market value of \$60,000. Assume the Indexation Factors were: for the quarter ending on June 30, 1991—100; for the quarter ending on March 31, 1993—150; and for the quarter ending on December 31, 1995—200. The taxable gain is calculated as follows:

Consideration on Disposal (deemed market value)	60,000
Indexed Purchase Price = $20,000 \times 200/100$	= -40,000
Indexed Improvements = $10,000 \times 200/150$	= <u>-13,333</u>
Taxable Gain	\$6,667

*Example C:* An Australian taxpayer purchases a capital asset for \$15,000 on June 2, 1995. On March 13, 1996, the taxpayer gives the asset to his son at a time when the asset's market value was \$25,000. Because the taxpayer held the asset for twelve months or less before disposal, the taxable gain is calculated as follows:

Consideration on Disposal (deemed market value)	25,000
Cost Base	<u>15,000</u>
Taxable Gain	\$10,000

Not all capital transfers, however, end in gain. To calculate capital loss on the disposal of an asset, the consideration on disposal is subtracted from the asset's "reduced cost base."<sup>113</sup> Reduced cost basis is the sum of each element of the "cost base" reduced by certain tax deductible amounts (e.g., depreciation).<sup>114</sup>

#### 4. *Tax on the Capital Gain*

Capital gains are assessed as income under the ITAA.<sup>115</sup> The ITAA, however, has developed a unique method of calculating the income tax on capital gains so as to alleviate the "bunching" effect caused by inclusion of all gain from the sale of an asset in a single tax year. According to the ITAA, one-fifth of net capital gains for the year are added to taxable income to determine what increase in taxation is caused by the addition of capital gain.<sup>116</sup> This one-fifth is added on top of the other assessable income, which means it will be assessed at the taxpayer's highest marginal rate. Once the amount by which the income tax is increased due to the addition of one-fifth of capital gains is determined, that figure is multiplied by five.<sup>117</sup> This ensures that capital gains are taxed at rates no higher (or not much higher) than the highest marginal rate for the taxpayer's non-capital income. It is an income averaging device.<sup>118</sup> Like indexation, this income averaging device is not an essential component of the Australian-model, and thus should not be incorporated in any Australian-based proposal to reform the U.S. gift tax, unless such a device is adopted for all capital gains in the United States.

*Example D:* An Australian taxpayer has a taxable income of \$10,000 before taking account of net capital gains. Assume the marginal rate on income ranging from \$0 to \$5,000 is 10% and \$5,000 to \$20,000 is 20%. The taxpayer had \$5,000 of net capital gains. What tax is payable?

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<sup>113</sup> ITAA § 160Z(1)(b) (1936).

<sup>114</sup> KEMP ET AL., *supra* note 80 at 94.

<sup>115</sup> ITAA § 160ZO (1936).

<sup>116</sup> This basis of taxation was instituted in recognition of the special hardship to some taxpayers resulting from being taxed at the marginal rate for the full amount of their net capital gains. GREENBAUM, *supra* note 39, at 133.

<sup>117</sup> Income Tax Rates Act § 3(1) (1986).

<sup>118</sup> GRAEME S. COOPER, ET AL., INCOME TAXATION 14-21 (1993).

Non-Capital Income Tax (5,000 x 10% and 5,000 x 20%)	1,500
Add 1/5 of Capital Gain (10,000 + 1,000 = 11,000)	
Increase Due to Capital Gain (200)	
Tax on Capital Gain (200 x 5)	+1,000
Total Tax	\$2,500

### 5. *Exemptions from CGT*

The CGT contains numerous exemptions, three of which are important for gift taxation. The first is a de minimis exemption for transfers of personal property, which has goals similar to the annual exclusion<sup>119</sup> in U.S. gift tax.<sup>120</sup> Under this exemption, most items of personal property<sup>121</sup> disposed of for less than \$5,000 (actual or deemed) are exempt from CGT.<sup>122</sup> The second exemption important to gift tax is the exemption of most automobiles.<sup>123</sup> The third exemption from CGT important to gift taxation is the exemption of gains from the disposal of the taxpayer's principal place of residence.<sup>124</sup> Some or all of these exemptions are necessary components to any proposal to replace the gift tax in the United States with an Australian-based model.

### C. *Australian Taxation of Testamentary Transfers*

Generally, the transfer of a capital asset at death, whether by will, intestacy or otherwise, does not constitute a disposal for CGT.<sup>125</sup> As a consequence, there is generally no realization of gain on assets transferred as a result of death.<sup>126</sup> However, such assets will be subject to CGT when later disposed of by the beneficiary.<sup>127</sup> In such cases, the beneficiary is

<sup>119</sup> I.R.C. § 2503(b)(1996).

<sup>120</sup> ITAA § 160ZE (1936).

<sup>121</sup> ITAA § 160B (1936). This provision of the Act exempts "personal use" assets from CGT. Personal use assets are those assets, other than land or buildings, that are owned by the taxpayer and kept primarily for the personal enjoyment of the taxpayer. *Id.*

<sup>122</sup> ITAA § 160ZE(1) (1936).

<sup>123</sup> See ITAA § 160A (1936).

<sup>124</sup> ITAA § 160ZZQ(12) (1936).

<sup>125</sup> ITAA § 160X (1936). The subsequent transfer by the personal representative to the beneficiary is also exempt from CGT, if the asset formed part of the decedent's estate. ITAA § 160X(3)(a) (1936).

<sup>126</sup> This rule applies to assets acquired after September 19, 1985. Assets purchased before that date are entirely exempt from CGT. ITAA § 160X (1936).

<sup>127</sup> The same tax consequences would occur if the asset were sold by representatives of the decedent's estate. ITAA § 160X(3)(b) (1936).

deemed to have acquired the asset at the deceased's indexed cost base.<sup>128</sup> In other words, unlike the U.S. tax system, the beneficiary does not obtain a "stepped-up" basis,<sup>129</sup> at least not in the sense of fair market value at the date of death. As a consequence, the exemption from CGT for assets acquired from a decedent is in effect a postponement of tax. When the beneficiary later disposes of the asset by sale, exchange or lifetime gift, he or she will be assessed CGT.<sup>130</sup> The rollover treatment for transfers at death is directly attributable to political pressure from the same groups that undermined the Australian estate and gift tax in the 1970s (farmers and small businesses).

*Example E:* An Australian taxpayer purchases a capital asset on April 29, 1991 for \$50,000. On June 11, 1994, the taxpayer dies, bequeathing the property to her niece. The Indexation Factors were: for the quarter ending on June 30, 1991—150; and for the quarter ending on June 30, 1994—200. The asset had a market value of \$150,000 at the taxpayer's death. In this case, there would be no CGT consequences for the taxpayer, as a transfer at death is generally not considered a disposal for CGT purposes. The niece's initial cost base in the asset is deemed to be the decedent's indexed cost base at the time of death ( $50,000 \times 200/150 = \$66,666$ ).

There is one exception to the rule exempting transfers by a decedent from CGT. Where an asset is bequeathed to a tax-exempt organization, the asset is deemed to be disposed of by the decedent immediately before his death for consideration equal to the market value of the asset at the date of death.<sup>131</sup> Any gain will be included in the income of the deceased's estate.<sup>132</sup> Otherwise, the gain would go entirely unrealized.

Before considering an Australian-based model for U.S. estate tax reform, readers should be aware of one necessary modification. Under the ITAA, the beneficiary of an asset transferred by a decedent obtains a cost base equal to the decedent's indexed cost base. Because capital gains are not indexed for inflation in the United States, the beneficiary's basis will

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<sup>128</sup> ITAA § 160X(5)(b) (1936). For assets acquired by the deceased before September 20, 1985, the beneficiary is deemed to have acquired the assets at their market value on the deceased's date of death. ITAA § 160X(5)(a) (1936).

<sup>129</sup> See I.R.C. § 1014 (1996).

<sup>130</sup> ITAA § 160X(3)(b) (1936).

<sup>131</sup> ITAA § 160Y(3) (1936).

<sup>132</sup> *Id.*

need to be calculated in a different manner. It is submitted, therefore, that an Australian-based model should provide either (1) that a gratuitous transfer by a decedent is a disposal for capital gains tax (and thus any gain is taxed at the decedent's death), and the beneficiary thereof receives a stepped-up basis equal to the market value of the asset at the decedent's death; or (2) that a gratuitous transfer by a decedent is not a disposal for capital gains tax (and therefore not taxed at the decedent's death), and the beneficiary thereof assumes the decedent's date of death basis without any adjustments. Both of these alternatives are feasible, but the former would probably generate more federal revenue because the Federal Treasury would acquire those funds at an earlier date. Considering the time value of money, this is a far more beneficial alternative.

### III. CONCLUSION

Is the Australian system of taxing gifts and bequests preferable to the U.S. transfer tax? The answer to this question is best left to the readers. In any event, such an answer almost assuredly requires a cost-benefit analysis of the Australian model. Bear in mind, the goal of this article was not to convince readers of the superiority of Australian tax law, but rather to interject the Australian tax model into the ongoing debate over transfer tax reform. Nevertheless, the advantages and disadvantages of the Australian system should be readily apparent even from the cursory review of Australian tax law presented in this article.

The primary advantages of the Australian model are (1) gifts and bequests would be taxed as part of the income tax system—the separate transfer tax system, with all of its complexities and expenses, could be dismantled, saving millions in collection costs; (2) the “stepped up” basis loophole, which Congress nearly filled in 1976,<sup>133</sup> would be abolished and instead the beneficiary would assume the decedent's date of death basis (transferred basis)—this modification alone should recoup the revenue lost when the existing estate and gift tax is repealed;<sup>134</sup> (3) the gift tax annual exclusion, which was designed to exempt customary gifts from taxation but which is used to funnel millions of dollars from generation to generation tax free, will be replaced by exemptions designed to exclude modest transfers of personal property, automobiles, and family homes from taxation; (4)

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<sup>133</sup> See I.R.C. § 1023 (repealed in 1980).

<sup>134</sup> As an alternative, transfers at death could be deemed disposals for capital gains taxation.

lifetime gifts of appreciated property will be taxed at the time of transfer rather than awaiting a re-transfer by the donee; (5) incorporation of the Australian model into U.S. tax law would be relatively simple, as most of the provisions necessary to tax gifts and bequests as capital gains are already in place in the Internal Revenue Code; and (6) the number of unreported, taxable transfers should decrease, as taxpayers are more familiar with the income tax rules and procedures than they are with the transfer tax system—arguably, a significant portion of the unreported transfers under the existing U.S. estate and gift tax system are due to inadvertence, not evasion.<sup>135</sup>

The primary disadvantages of the Australian model are (1) cash gifts and bequests, as well as gifts and bequests of unappreciated property, elude taxation;<sup>136</sup> (2) there is no exemption (permanent or temporary) for intra-family transfers of closely-held businesses or farms, such as that available under section 2032A of the Internal Revenue Code; (3) there is no exemption for gifts made for educational and medical purposes<sup>137</sup>—of course, such an exemption could be added to the Australian model; (4) there is no exemption for transfers between current spouses, though transfers resulting from the breakdown of marriage are exempt;<sup>138</sup> and (5) there is no built-in structure for differentiating complete transfers from incomplete transfers—however, a significant part of this structure could be borrowed from the existing U.S. transfer tax system.

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<sup>135</sup> Inadvertence and mistake are not defenses against tax evasion crimes. They are, however, frequently pleaded as defenses. *See e.g.*, *United States v. Johnson*, 634 F.2d 735, 737-38 (4th Cir. 1980).

<sup>136</sup> It could be argued this exemption is warranted by the fact that the entire basis of the property has already been subjected to income taxation in the hands of the transferor.

<sup>137</sup> *See* I.R.C. § 2503(e) (1996).

<sup>138</sup> ITAA § 160ZZM (1936).